CHAPTER I
INTRODUCTION

1.1   Background of the Study

Indonesia is one of the largest among Southeast Asian countries and also as the largest archipelago in the world, with five large islands: Sumatera, Java, Kalimantan, Sulawesi, and Papua. Indonesian administrative are divided into provinces and each province consists of several districts and municipalities. Therefore, centralized government in Indonesia is not efficient to produce public goods and services because centralized planning and decision making, and a huge financial dependency of local authorities on grants from the center gave local government little room to maneuver. According to Nasution (2016, p.1), "Since the government passed the Law Number 22 Year 1999 regarding local government and Law Number 25 Year 1999 regarding financial balance between the central government and local government". The local government in Indonesia have the autonomy to administer their region and the local governments also have the autonomy to supervise the financial on that region. However, since the laws are no longer in accordance with the demands of the government development system in Indonesia and the politics, the government revised the law.

Since 2001, Indonesia was struck by "Decentralization Big Bang". New provinces emanate rapidly throughout the years, because the law authorizes the local government to organize and manage their own household and have the opportunity to form a new district/ municipal if it meets the requirements that are set by the law.

Based on table 1.1 we have the names of province with each capital city. Under the decentralization system, each province will have their original local government revenue (*Pendapatan Asli Daerah/ PAD*) that will contribute to the state revenue. Original local government revenue consists

of all revenues generated from each province that is collected by the local government under the local regulation in accordance with the applicable legislation. Original local government revenue has an important role because this will reflect the province on how financially independent that province to finance their governmental activities and regional development.

Table 1.1 Lists of Provinces in Indonesia and Its Capital

Name of Province	Capital city
Aceh	Banda Aceh
Bali	Denpasar
Bangka Belitung	Pangkal Pinang
Banten	Serang
Bengkulu	Bengkulu
DI Yogyakarta	Yogyakarta
DKI Jakarta	Jakarta
Gorontalo	Gorontalo
Jambi	Jambi
West Java	Bandung
Central Java	Semarang
East Java	Surabaya
West Kalimantan	Pontianak
South Kalimantan	Banjarmasin
Central Kalimantan	Palangkaraya
East Kalimantan	Samarinda
North Kalimantan	Tanjung Selor
Riau Island	Tanjung Pinang
Lampung	Bandar Lampung
Maluku	Ambon
North Maluku	Ternate
West Nusa Tenggara	Mataram
East Nusa Tenggara	Kupang
Papua	Jayapura
West Papua	Manokwari
Riau	Pekanbaru
West Sulawesi	Mamuju
South Sulawesi	Makasar
Central Sulawesi	Palu
Southeast Sulawesi	Kendari
North Sulawesi	Manado
West Sumatera	Padang
South Sumatera	Palembang
North Sumatera	Medan

Source: Prepared by the writer (2019)

The improvement of original local government revenue must be done by local governments in order to be able to finance their own public needs, so that the fiscal dependency of local government to the central government decreases and eventually the region can be financially independent. According Law Number 33 Year 2004 regarding, financial balance between central government and local government shows how original local government revenue can be collected.

Local tax and regional retribution are the second largest source of local revenue. Every region has the tax base that differs depending on the policy from the local government.

According to Ferede and Dahlby (2012) in Khumbuzile and Khobai (2018, p.1), "Taxes can increase the cost of capital and reduce incentives to invest, to the point that high tax rates discourage investments thereby adversely affecting economic growth".

According to Law Number 28 Year 2009, Local tax is a mandatory contribution to a region that is owed by each individual or entities that are enforceable under the law, by not getting the rewards directly and used for the purpose of region for improving the prosperity of the public. And from the Law Number 28 Year 2009, local taxes are divided into several following:

1. Motor vehicle Tax
2. Excise/ Tax for Transfer of Owership of Motor Vehicle
3. Motor Vehicle Fuel Tax
4. Surface Water Tax
5. Cigarette Tax
6. Hotel Tax
7. Restaurant Tax
8. Entertainment Tax
9. Advertising Tax
10. Street Lightning Tax
11. Tax on Non-Metal Mineral and Rocks

12. Parking Tax Ground Water Tax
13. Tax on Swallows' Nests
14. Rural and Urban Land and Building Tax
15. Excise/ Tax for Acquiring Right on Land and Building.

Just as the general taxes, local taxes also play as a budgetary for the locals and regulatory. In theory, taxes may have both negative and positive effects on economic growth.

The positive effects from taxation is by assuming that each individuals and ventures contributes on paying their taxes, hence the government will gain resource from the tax revenues and have the greater ability to transform resources into output. By having the advantage from the tax payers, the government will have more budgets to the public sectors to protect the telecommunication, building, roads, and property also to ensure the serenity and infrastructure for the domestic runs smoothly, therefore it may help to building a greater economic growth.

According to Murkur (2001) in Ejoh et al., (2016, p.12), "Meeting the needs of society calls for huge funds which an individual or society cannot contribute alone and one medium through which funds is derived is through taxation". Taxes play a vital role in financial arrangement and growth of infrastructure, it is one of the main source of open income, even economic policies are based on expected tax revenue and tax policy is a fundamental component of economic policies for each nation in order to preserve their global competitiveness and development, it is attractive for every government to generate tax revenue to finance essential expenditures without recourse to excessive public sector borrowing.

The negative effect of taxation is as the tax gets larger, individuals and ventures may create incentives to seek out activities that can minimize their tax payments or the worst scenario from a high taxation individuals and ventures may do an evasive action for paying their taxes, because at a relatively high tax level, taxpayers revolt because they thought the price of

government services is viewed as too high in relation to the volume or quality of service provided.

By having both positive and negative effect to the economic growth, this correlation has attracted writer to analyze the relationship between taxes and economic growth.

Khumbuzile and Khobai (2018) dissertation found that the results indicated that the impact of taxes on economic growth is negative and significant in the short and long-run.

On the other hand, A significant minority of studies found that there are some positive correlation between tax and economic growth. Olufemi et al., (2018) concluded that tax revenue have positive and significant impact on the economic growth in Nigeria.

Ali et al., (2018) concluded that the domestic tax revenue has a positive and significant impact on economic growth, domestic revenue is important for enhancing economic growth, and more attention should be given to the generation of domestic revenue.

This paper attempts to study the effect of local tax on economic growth. Most studies find a negative correlation between taxes and economic growth. However, a significant minority of studies no correlation, and some find evidence of a positive correlation.

Based on the background study, then the researcher is interested to conduct the research with the title as follows: **"The Effect of Local Tax Revenue on Economic Growth in Sumatera"**

1.2   Problem Limitation

Based on the background above, the limitations of the problem in this study are:

1. This research focus on 2010 - 2017 because Indonesia local tax continues to grow from year 2010 - 2017.

2. This research focus on local tax that consist of Province Tax and Districts/ Municipal Tax

3. The object of study is Sumatera with economic growth as dependent variable and local tax revenue as independent variable.

1.3 Problem Formulation

Based on the background and problem limition, so the problem formulations for this research is: What local tax revenue impacts economic growth in Sumatera from 2010 - 2017?

1.4 Objective of the Research

Based on the background and problem limition, the objective of the research is: To analyze the impact of local tax revenue to economic growth.

1.5 Benefit of the Research

1.5.1 Theoretical Benefit

The results from this research are expected to provide information related to the research objective, and provides a concrete answer to the questions from the research objectives. As an academic point of view, this research may also be a reference to a similar research about the relationship between local tax revenue to economic growth.

1.5.2 Practical Benefit

This research may also provide advice for the policy maker to seek a better policy that will make local tax revenue to be more impecable to help the growth of Indonesian economy. This research also give benefit for author to apply the knowledge.

1.6 Systems of Writing

The systematics of writing this thesis is briefly described in the contents of each chapter, which consists of five chapters. The contents of each chapter in this study as follows

CHAPTER I: **INTRODUCTION**

This chapter starts with background of study of what local tax revenue impact the economic growth. Problem limitations will be limited. Then, problems will be formulated, along with the explanation of objective and benefit of the research. Lastly, an overview of the main chapters in this study will be presented in systems of writing.

CHAPTER II: **LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT**

This chapter explains about theoretical backgrounds of tax, local revenue source, original local government revenue (*Pendapatan Asli Daerah/ PAD*), local tax, types of regional taxes, constribution of local tax to original local government revenue, GRDP, and economic growth to facilitate this study. Literature review will also be presented to support this study. Then, hypothesis will be developed along with the research model and framework of thinking.

CHAPTER III: **RESEARCH METHODOLOGY**

This chapter explicates the research design, which is quantitative research. Then, population, sample and definition and measurement of variable will be elaborated. Lastly, the method of the analysis will be explained.

CHAPTER IV: **DATA ANALYSIS AND DISCUSSION**

This chapter explains the general view of the research object which is related to the effect of local tax

revenue on economic growth, then elaborates the data analysis result (descriptive statistic result, data quality testing result, hypothesis testing result), as well as the discussion result of the research.

CHAPTER V: **CONCLUSION**

The last chapter consists of the conclusion of the research and the description of the implications. Lastly, recommendation of the research will be given and it is expected to be useful to the readers.